TITLE 2. CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
NOTICE OF PROPOSED REGULATORY ACTIONS

NOTICE IS HEREBY GIVEN that the Board of Administration (Board) of the California Public Employees' Retirement System (CalPERS) proposes to take the regulatory action described below after considering public comments, objections, or recommendations.

I. PROPOSED REGULATORY ACTION

In this filing, the Board proposes to add Article 7.5 entitled "Participation in Risk Pools" in Title 2 of the California Code of Regulations. Sections 584 through 584.10 would be added to Article 7.5. This proposed regulatory action pertains to the participation of contracting agencies, county offices of education, school districts and community college districts in risk pools for retirement purposes.

II. WRITTEN COMMENT PERIOD

Any interested person may submit written comments relevant to the proposed regulatory action. The written comment period closes at 5:00 p.m. on February 16, 2004. The Regulations Coordinator must receive all written comments by the close of the comment period. Comments may be submitted via facsimile at (916) 326-3379; e-mail at joe_parilo@calpers.ca.gov; or mailed to the following address:

Joe Parilo, Regulations Coordinator
California Public Employees' Retirement System
400 P Street, Room 1120
P.O. Box 942702
Sacramento, California 94229-2702
Telephone: (916) 326-3484

Please note that this is the second public comment period on this proposed regulatory action. Written comments received during the initial comment period, as well as comments received at the prior public hearing held on October 15, 2003, will be responded to in writing as part of the rulemaking file and need not be resubmitted.

III. PUBLIC HEARING

Comments on the proposed actions will also be taken at a public hearing to be placed on the agenda of the regularly scheduled meeting of the CalPERS Benefits and Program Administration Committee:

February 18, 2003
1:30 p.m. (or upon conclusion of the Health Benefits Committee meeting)
California Public Employees' Retirement System
400 P Street
Sacramento, California 95814

IV. ACCESS TO HEARING ROOM

The hearing room will be accessible to persons with mobility impairments, and it can be made accessible to persons with hearing or vision impairments upon advance request to the Regulations Coordinator.

V. AUTHORITY AND REFERENCE

The CalPERS Board of Administration (Board) has general authority to take regulatory action under Government Code section 20121. The Board has specific authority to adopt proposed sections 584 through 584.10 under Government Code section 20840. This action would implement, interpret and make specific Government Code section 20840.

VI. INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Government Code section 20840, subsection (b) authorizes the Board to create, combine or eliminate risk pools for local miscellaneous and local safety members. Proposed sections 584 through 584.10 would establish criteria for participation in risk pools by contracting agencies, county offices of education, school districts and community college districts.

Proposed section 584 provides plan definitions; proposed section 584.1 defines required participation into risk pools for existing contracting agencies; proposed section 584.2 defines required participation into risk pools for new contracting agencies; proposed section 584.3 defines optional participation into risk pools; proposed section 584.4 addresses participation in risk pools by county offices of education, school districts and community college districts; proposed section 584.5 addresses amortization of side funds; proposed section 584.6 addresses assignment of rate plans to risk pools; proposed section 584.7 addresses the process of leaving and transferring between risk pools; proposed section 584.8 addresses the classification of benefit provisions; proposed section 584.9 allows for the merger of risk pools; and proposed section 584.10 addresses participation in risk pools by superfunded agencies. Government Code section 20840 authorizes the Board to adopt regulations establishing criteria for participation in risk pools.

VII. EFFECT ON SMALL BUSINESS

The proposed regulatory action does not affect small business because it applies only to public agency participation in risk pools.

VIII. DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

A. MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS: The proposed regulatory action does not impose a mandate on local agencies or school districts.

B. COST OR SAVINGS TO ANY STATE AGENCY: The proposed regulatory action does not impact costs or savings for any state agency.

C. COST TO ANY LOCAL AGENCY OR SCHOOL DISTRICT: The proposed regulatory action does not impact costs or savings for any local agency or school district, such that costs would qualify for reimbursement under Government Code section 17500 et seq.

D. NONDISCRETIONARY COSTS OR SAVINGS IMPOSED ON LOCAL AGENCIES: The proposed regulatory action does not impose non-discretionary costs or savings on local agencies.

E. COSTS OR SAVINGS IN FEDERAL FUNDING TO THE STATE: The proposed regulatory action does not impact any federal funding to the state.

F. ADVERSE ECONOMIC IMPACT: CalPERS has made an initial determination that the proposed regulatory actions will not have a significant statewide adverse economic impact directly affecting businesses including the ability of business in California to compete with business in other states.

G. COST IMPACT ON REPRESENTATIVE PRIVATE PERSONS OR BUSINESSES: CalPERS is not aware of any cost impacts that a representative private person, or business would necessarily incur in reasonable compliance with the proposed action.

H. IMPACT ON JOBS AND BUSINESSES WITHIN CALIFORNIA: The proposed regulatory action will not: (1) create or eliminate jobs within California; (2) create new businesses or eliminate existing businesses within California; or (3) affect the expansion of businesses currently doing business within California.

I. EFFECT ON HOUSING COSTS: The proposed regulatory action has no significant effect on housing costs.

IX. CONSIDERATION OF ALTERNATIVES

The Board must determine that no reasonable alternative considered by the Board or that has otherwise been identified and brought to the attention of the Board would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed action. The Board invites interested persons to present statements or arguments with respect to alternatives to the proposed regulation at the above mentioned hearing or during the written comment period.

X. CONTACT PERSONS

Please direct inquiries concerning the substance of the proposed regulatory action to:

David Lamoureux
Actuarial and Employer Services Division
California Public Employees' Retirement System
P.O. Box 942709
Sacramento, California 94229-2709

Telephone: (916) 341-2473
Fax: (9l6) 341-2744
E-mail: david_lamoureux@calpers.ca.gov

Please direct requests concerning processing of this regulatory action to Joe Parilo, Regulations Coordinator, at the address shown above, or Marilyn Clark at (916) 326-3007.

XI. AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

The entire rulemaking file is available for public inspection through the Regulations Coordinator at the address shown above. To date the file consists of this notice, the proposed text of the regulation, and the Initial Statement of Reasons (ISOR). A copy of the proposed text and the ISOR is available at no charge upon telephone or written request to the Regulations Coordinator.

The Final Statement of Reasons can be obtained, once it has been prepared, by written request to Joe Parilo, Regulation Coordinator, at the address shown in Section II.

For immediate access, the regulatory material regarding this action can be accessed at CalPERS' web site at www.calpers.ca.gov under Members, About CalPERS, Proposed Regulatory Actions.

XII. AVAILABILITY OF MODIFICATIONS TO PROPOSED AMENDMENT

The Board may, on its own motion or at the recommendation of any interested person, modify the proposed text of the regulations after the public comment period has closed. It may amend section 584 through 584.10 as modified if the changes are sufficiently related to the original text so the public could have anticipated them.

If the Board modifies its regulatory action in this manner, it will prepare a comparison of the original proposed text and the modifications for an additional public comment period of not less than 15 days prior to the date on which the Board adopts, amends or repeals the resulting regulation. A copy of the comparison text will be mailed to all persons who submitted written comments or asked to be kept informed as to the outcome of this regulatory action.

PROPOSED REGULATORY ACTION BY CALPERS

Adoption of Title 2, Chapter 2, Subchapter 1, Article 7.5

ARTICLE 7.5 PARTICIPATION IN RISK POOLS

§ 584. Risk Pools - Definitions

(a) For purposes of this Article, a "Rate Plan" consists of all CalPERS members for which a single employer contribution rate is produced annually.

(b) For purposes of this Article, a "Side Fund" shall be the difference between the actuarial value of assets and the actuarial liabilities of the rate plan at the time of joining a risk pool.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.1. Risk Pools – Required Participation for Existing Contracting Agencies

Following the creation of risk pools pursuant to Section 20840 of the Government Code, any existing contracting agency with a rate plan of less than 100 active members on any annual actuarial valuation date shall be required to participate in a risk pool. Participation shall be effective as of that valuation date for all members of that rate plan, but no earlier than the June 30, 2003 actuarial valuation which will be used to set employer contribution rates for fiscal year 2005-2006.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.2. Risk Pools – Required Participation for New Contracting Agencies

A new contracting agency with CalPERS following the creation of risk pools shall be required to participate in a risk pool if the number of active members in the rate plan is less than 100 at the time of the initial actuarial valuation.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.3. Risk Pools – Optional Participation

A contracting agency with 100 or more active members on each annual valuation date after June 30, 2003 may, by amendment to its contract, participate in a risk pool provided that the actuary determines such participation will not be unfavorable to other agencies in the pool. In the event that such participation would be unfavorable, the matter may be referred to the CalPERS Board for a hearing.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.4. Risk Pools – County Offices of Education, School Districts and Community College Districts

Notwithstanding Section 584.1, county offices of education, school districts and community college districts shall not be required to participate in a risk pool. County offices of education, school districts and community college districts shall only be allowed to establish a contract with CalPERS to participate in a risk pool if the service retirement formula of the risk pool provides higher factors at all ages than the service retirement formula applicable to school members.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.5. Risk Pools – Amortization of Side Funds

The side fund shall be amortized at the actuarially assumed investment return pursuant to CalPERS Board policies. All investment gains and losses on the side fund that exceed or fall below the actuarially assumed investment return shall be attributed to the risk pool.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.6. Risk Pools – Assignment to Risk Pools

A rate plan participating in a risk pool shall be assigned to one of the risk pools based on the service retirement formula applicable to its active members.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.7. Risk Pools – Leaving and Transferring Between Risk Pools

Any contracting agency participating in a risk pool shall be allowed to transfer the assets and actuarial liabilities of its rate plan into another risk pool by contracting for a service retirement formula offered by the other risk pool. For this purpose, the assets to be transferred shall be the pro-rata share of the current pool's net assets (net of all side funds) plus the rate plan's remaining side fund, as determined by the actuary. Following the transfer to the new pool, a new side fund shall be established equal to the difference between the assets brought into the new pool and the product of the actuarial liabilities of the rate plan under the new service retirement formula and the net funded ratio of the new pool as determined by the actuary. A contracting agency shall not be allowed to terminate its participation in a risk pool, unless the agency's contract is terminated pursuant to Sections 20570, 20571, or 20572 of the Government Code. Upon termination of the contract, the affected members shall become part of the terminated agency pool pursuant to Section 20578 of the Government Code.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.8. Risk Pools – Classification of Benefit Provisions

The CalPERS Board shall separate, in accordance with criteria established by Board policies, the benefit provisions available to a contracting agency into various classifications that will be handled as follows:

(a) Class 1 benefits may vary by rate plan within each risk pool. Agencies contracting for a Class 1 benefit will be responsible for the past service liability associated with such benefit and will be required to pay a surcharge established by the actuary to cover the ongoing cost (normal cost) of the Class 1 benefit.

(b) Class 2 benefits may vary by rate plan within each risk pool. Agencies contracting for a Class 2 benefit will be required to pay the full one time cost of the benefit, as established by the actuary.

(c) Class 3 benefits may vary by rate plan within each risk pool. However, the employer contribution rate will not vary within the risk pool due to the Class 3 benefits.

The CalPERS Board reserves the right to modify the classification of benefits.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.9. Risk Pools – Merger of Risk Pools

In the event that the number of contracting agencies participating in a risk pool is determined by the actuary to be too small to reduce the volatility in employer contribution rates caused by unexpected demographic events, the risk pool will be merged with another risk pool identified by the actuary.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

§ 584.10. Risk Pools – Superfunded Status

For employers participating in a risk pool, the actuary shall determine on an annual basis whether or not the employer's rate plan is superfunded pursuant to Section 20816 of the Government Code. In determining whether the rate plan is superfunded, the actuary shall use assets equal to the pro-rata share of the current pool's net assets plus the plan's remaining side fund. Superfunded plans may cover its employees' normal member contributions using its employer assets. Such transaction will be tracked through the rate plan's individual side fund.

NOTE: Authority cited: Sections 20120, 20121 and 20840, Government Code. Reference: Section 20840, Government Code.

INITIAL STATEMENT OF REASONS

Adoption of sections 584 through 584.10 – Participation in Risk Pools

Description of Public Problem, Administrative Requirement, or Other Condition or Circumstance that the Regulation is Intended to Address: Over the years, CalPERS has experienced phenomenal growth. This growth has been in assets, covered members, contractual employers and, for better or worse, in pension benefit contract options and the number of distinct plans that require service. Because of the growing number of plans and the increasing complexity the delivery of quality customer service has become more and more difficult.

More importantly, the manner of growth may not serve the members or employers well. There are over 1,400 separate plans at CalPERS with less than 100 active members. Under the current contract methodology each employer and its employees, regardless of size, choose from the wide variety within the existing pension benefit menu. Hundreds of these small employers select benefits that carry financial risks too large for a small group to accept on their own. All too often a single catastrophic event such as death or disability can cause a small employer's contribution rate to increase by 50%, or even 75%, of total payroll. Even one unexpected early retirement in a small plan can have a devastating impact on the employer's contribution rate. Pooling assets and liabilities across employers to produce large risk sharing pools would dramatically reduce or eliminate the large fluctuations in the employer's contribution rate caused by unexpected demographic events.

In February 2002, the CalPERS Board approved the sponsorship of legislation addressing the creation and administration of risk pools and the mandated participation in the risk pools for smaller contracting agencies. In October of 2002, Assembly Bill 1974 was chaptered and Sections 20840 and 20841 were added to the Government Code. These Sections require regulations to be adopted to establish the details of the administration of risk pools.

Specific Purpose: The proposed regulations are intended to meet the requirements of Government Code Sections 20840 and 20841, establish the various rules and criteria necessary for implementing risk pools and mandate participation into risk pools for rate plans with less than 100 active members.

Necessity: If the CalPERS Board creates risk pools, Section 20840 of the Government code requires that the CalPERS Board establish, by regulation, the criteria under which contracting agencies must participate in a risk pool and the criteria under which contracting agencies, county offices of education, school districts and community college districts may participate in risk pool.

If risk pools are created, Section 20840 also provides that county offices of education, school districts and community college districts are only allowed to participate in risk pools with a retirement formula higher than the retirement formula applicable to school members.

As mentioned earlier, small employers contracting with CalPERS for retirement benefits carry financial risks too large for a small group to accept on their own. Therefor, participation into risk pools for small plans will be mandated. Under Section 20840, criteria to mandate participation in risk pools must consider the expected variability of the employer contribution rate due to demographic events. A study performed by CalPERS actuaries demonstrated that liability losses due to demographic events cause 2 to 6 times more volatility in the employer rates of small employers than larger employers. The highest volatility was seen for plans with less than 20 active members. However, the study also showed that plans with as many as 50 active members are subject to volatility that could cause large swings in employer contribution rate.

As a result of this study and to ensure the viability of risk pools, the proposed regulations mandate participation in a risk pool for all existing and future rate plans at CalPERS with less than 100 active participants. The proposed regulations also allow contracting agencies with 100 or more active participants to join a risk pool unless CalPERS actuarial staff deem such event to be unfavorable to other agencies participating in the risk pool. In such cases, if the agency requests a Board hearing, the issue will be referred to the CalPERS Board.

Finally, Section 20840 provides that the Board shall establish, by regulation, the circumstances under which a contracting agency may cease participation in risk pools for a member classification. To avoid potential abuse by employers and to ease the administration of risk pools, the regulation will state that leaving the risk pool structure will only be possible through termination of the contract with CalPERS. Once an employer joins a risk pool, it can only move from one risk pool to another by contracting for a higher service retirement formula. If an employer decides to cease participation in risk pools and terminate its contract, the asset and the liabilities of the plan will then be moved to the terminated agency pool.

In addition to the requirements as set forth in Section 20840, the proposed new regulation will also address how the financial position of each plan will be taken into account at the time of joining a risk pool.

Over the last few years, the main concern expressed by employers over the creation of risk pools was with respect to the status of their own surplus or unfunded liabilities. Employers wanted to ensure that they would not share their existing surplus and would not pay for other employers' unfunded liabilities.

The proposed regulations address this issue by specifying that the employer contribution rate take into account the assets and liabilities brought into the risk pool through the creation of a side fund.

The regulations specify that the side fund will be amortized at the actuarially assumed investment return over a fixed period of time, as established under CalPERS Board policies. They also specify that all investment gains and losses on the side fund shall be credited to the risk pool.

One of the main reasons for creating risk pools is to help reduce the rate fluctuations that small employers are facing on their own. It is possible that, over time, a risk pool will become too small to reduce the volatility in employer contribution rates caused by unexpected demographic events. If such scenario occurs, the regulations ensure that the CalPERS Board has the authority to combine such a pool with another existing pool.

As a result of the growth in the number of different benefit options available at CalPERS, current contracts contain over 650 unique benefit packages. In order to attempt pooling with this wide array of benefit packages, it was decided to separate existing benefits into three classifications and treat each classification differently in pooling plans together. Section 584.8 of the regulations defines these three classifications and how they are treated. Each optional benefit will be assigned to one of the classification in accordance with criteria established by Board policies. When new benefits become available as a result of legislation, the Chief actuary will determine their classification in accordance with the criteria established in the Board policy.

Finally, the regulations specify that the actuary must determine on an annual basis whether or not the employer's rate plan is superfunded within the pool pursuant to Section 20816 of the Government Code. This will ensure that sponsors of superfunded rate plans will still be able to make employee contributions out of surplus after joining a risk pool.

Adoption of the proposed regulations will enable the Board to create risk pools that will be viable, fairly administered and help reduce the fluctuation in employer contribution rates.

<u>Technical, Theoretical and/or Empirical Studies, Reports or Documents</u>: Not applicable.

<u>Alternatives to the Regulatory Action and CalPERS' Reasons for Rejecting Those Alternatives</u>: CalPERS has considered alternatives to this proposal, and has determined that there is no more effective way to carry out its purpose that would be less burdensome.

Alternatives to the Regulatory Action that Would Lessen any Adverse Impact on Small Businesses: The proposed action has no cost impact on small businesses because it applies only to public agency employee retirement benefits.